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RUEHKA/AMEMBASSY DHAKA 2254
RUEHLM/AMEMBASSY COLOMBO 1467
RUEHLO/AMEMBASSY LONDON 7178
RUEHML/AMEMBASSY MANILA 2929
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TAGS: EFIN ECON EINV PREL PK
SUBJECT: INFLATION CONCERNS TRUMP GROWTH: PAKISTAN RAISES DISCOUNT RATE TO 10.5 PERCENT

Summary

¶1. (SBU) The State Bank of Pakistan (SBP) further tightened monetary policy by raising its discount rate by half a percentage point to 10.5 percent and increasing cash reserve requirements for deposits up to one year maturity. According to the SBP's semi-annual Monetary Policy Statement issued January 31, the discount rate was raised to counter strong demand pressures and Pakistan's rising inflation rate. The SBP believes that inflation risks outweigh any effect that tighter monetary policy will have on Pakistan's growth rate. The SBP maintains that economic growth will be 7 percent in FY2008. The State Bank cited the large current account deficit and fiscal imbalances as key indicators demand is still strong, despite progressive tightening of monetary policy over the last three years. It also criticized the large and growing government borrowing from the banking system to finance the 82.3 percent increase in the fiscal deficit. End summary.

State Bank of Pakistan tightens monetary policy -- again

¶2. (SBU) The State Bank of Pakistan announced the monetary policy for the first half of the calendar year 2008 on January 31, 2008. The SBP further tightened monetary policy by raising its discount rate for commercial lenders by half a percentage point to 10.5 percent and increasing cash reserve requirements by 100 basis points for deposits up to one year maturity effective February 1. Term deposits of over a year remain zero rated as an incentive to banks to mobilize long term deposits. The SBP pointed out that, even with the current rate hike, real lending rates are far lower in Pakistan than in other South Asian countries.

Current GOP fiscal policy makes monetary policy management difficult

¶3. (SBU) The GOP's fiscal policy in the first half of FY08 substantially deviated from its monetary policy framework. Spending far surpassed revenues. As a result, the commercial banks and the central bank financed almost 60 percent of the budget deficit from July 1, 2007 until January 29, 2008. The latest available Ministry of Finance data for the first quarter of FY08 shows that fiscal deficit has reached Rs.158.1 billion ($2.55 billion) -- 82.3 percent higher than last year. Growing subsidy financing requirements in the wake of increasing international oil prices; higher interest payments on domestic debt, which almost doubled to reach Rs111.1

billion ($1.79 billion); and increased development and infrastructure expenditures, which grew by 89.5 percent to support the growing economy, are the main factors contributing to the growth of the fiscal deficit.

¶4. (SBU) Large increases in the fiscal deficit have made monetary policy management more difficult. An absence thus far in FY08 of privatization receipts, Global Depository Receipts and government bonds, which have in the past two years financed almost 41 percent of the budget deficit, also contributed to increased government borrowing from the Central Bank. Despite the political uncertainty and pressures of government borrowing on the financial system, private sector credit still managed to grow by 10.4 percent from July 1 to January 19 in line with last year's trend and indicating continued strong demand.

Demand still strong despite progressively tight monetary policy

¶5. (SBU) The SBP basically admits in the current monetary policy statement that tight monetary policy, especially since the previous policy rate increase in June 2007, has not been effective. M2 grew at an annualized rate of 19.2 percent from July 1 to January 19, compared to a 13.7 percent increase target for FY08. Core inflation rose to 8.7 percent year on year in December 2007, 2.3 percentage points above last year's level. The consumer price index increased 8.8 percent in December 2007, reflecting the undercurrents increases in food prices. The food price index rose 12.2 percent in December ¶2007.

Lack of foreign inflows to offset fiscal deficit

¶6. (SBU) The SBP highlighted that a slowdown in the U.S. economy, mainly due to the sub-prime mortgage crisis and subsequent lack of

financial liquidity, coupled with the recent domestic uncertainty in Pakistan are likely to have negative implications on export performance. (Comment: While we have not seen the numbers yet, exports will take a dip due to the closure of the Karachi port in late December following Bhutto's assassination. Analysts here are also concerned that any slow down in economic growth in the U.S., Europe, or both will bode ill for Pakistan's textile exports. End comment.) At the same time, high international oil and food commodity prices combined with strong non-commodity import demand will keep the pressure on the current in the near future. For example, machinery imports increased by 8 percent, while metal product imports increased by 10 percent.

Foreign inflows decreasing

¶7. (SBU) Financial inflows necessary to finance the current account deficit have decreased in the second quarter of FY 2008. Portfolio investment flows decreased 92.1 percent in the first six months of the FY08 fiscal year, contributing to the growing current account deficit. The share of portfolio capital in total foreign investment flows fell from 41 percent in the first half of FY07 to 4.7 percent in the first half of FY08. Only remittances recorded an increase. As a result of decreased inflows and increased commodity prices, Pakistan's current account deficit has increased from $4.6 billion to $6.1 billion in the first half of the current fiscal year, despite a 10 percent increase in FDI and a 19.3 percent increase in remittances. In addition, the Pak Rupee-U.S. dollar exchange rate depreciated by 3.7 percent between July 1, 2007 and January 29, 2008. Apart from putting pressure on foreign exchange reserves, this depreciation will contribute to inflationary pressures in the coming months because of the higher cost of imported inputs. Increasing energy, wheat and other commodity imports are likely to exacerbate this trend.

Comment

¶8. (SBU) The further tightening of monetary policy may have negative implications for Pakistan's already slowing economy, but the State Bank of Pakistan is in a difficult position. Inflation and pocketbook issues are the public's key concern. It already lost

the battle to stem increased government borrowing. We anticipate that the GDP growth may be between 5 to 6 percent in the current fiscal year versus the government's revised target of 7 percent, a view increasingly shared in Pakistan's financial community, if not by the government. The tightening of monetary policy may finally reduce private sector credit growth, which could further slow down overall economic growth. Increased government borrowing from both the central bank and private banking system were already crowding out the private sector credit, even before the latest rate increase. One worrisome factor is that the money supply has expanded despite a drop in net foreign assets, which would have helped to finance the current account deficit. This trend is putting increasing pressure on Pakistan's foreign reserves, which have dropped about $1 billion since their October 2007 high. End comment.

PATTERSON